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To: Rick Buy
Rick Causey

From: Jordan Mintz *Jordan*

Department: Enron Global Finance—Legal

Subject: **LJM Approval Process -- Transaction Substantiation**

Date: March 8, 2001

With the year-end and recent Board meetings behind us, and our now being in the midst of proxy season, I thought it might be timely to memorialize my observations and summarize my recommendations for refining our compliance with the procedures approved by Enron's Board of Directors (the "Board") with respect to the Company's transacting with LJM. Briefly stated, it is my view that the Company needs to improve both the *process* it follows in executing such transactions and implement improved procedures regarding *written substantiation* supporting and memorializing the Enron/LJM transactions; at the same time, it is also my view worthwhile improvements can be accomplished without significant disruption to commercial efforts.

More specifically, my recommendations focus on two areas: the first is the need for the Company to implement a more active and systematic effort in pursuing non-LJM sales alternatives before approaching LJM, and then to create more extensive written documentation substantiating such efforts; the second is to modify the LJM Approval Checklist so as to impose a more rigorous testing of the fairness and benefits realized by Enron in transacting with LJM — and balancing such benefits against perception and shareholder relations issues such transactions may present.

To that end, what follows below is: relevant background regarding the Board's approval for transacting with LJM; my "due diligence" findings relating to the Company's compliance with such approval; and recommendations for improvement to be effective for the 2001 year.

Overview

As you know, the sensitivities surrounding Enron's transacting with LJM primarily stem from three areas: whether such transactions are being conducted at arms-length in such a clear and convincing fashion that they will be respected from a GAAP earnings perspective; whether the benefits realized by Enron from such transactions are sufficiently "compelling" from an investor's perspective to negate perceptions, however unwarranted, of an "interested" dealing; and whether such transactions are in the best interests of the Company and, thus far, consistent with the Board's carrying out its fiduciary duties and in compliance with the Company's Code of Ethics. In order to address these three critical and often-overlapping concerns, the Board has previously approved the following procedures and controls:

- (1) Enron and LJM are not obligated to one another to transact;
- (2) Enron's Chief Accounting and Risk Officers are to review and approve the terms all transactions Enron or an affiliate enters into with LJM;

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- (3) The Board's Audit and Compliance Committee shall annually review all transactions completed that year and make any recommendations they deemed appropriate; and
- (4) The Board is to determine, also annually, that Andrew Fastow's controlling position at LJM and his involvement as a counterparty to Enron does not adversely effect the best interests of the Company.

Additionally, although not explicitly provided for by the Board, the Finance Committee also annually reviews all Enron/LJM transactions, but may review on an *ad hoc* basis, as needed.

To supplement the Board's mandated procedures, Enron and LJM also agreed to an additional control precluding Mr. Fastow (and Michael Kopper, also a senior level professional at both Enron and LJM) from negotiating on behalf of Enron in transactions with LJM.

The Company subsequently adopted a written "LJM Approval Sheet" to generally describe the business nature of any Enron/LJM transaction, including the deal terms and anticipated economics to Enron. This Approval Sheet is supplemented with an "Issues Checklist", which captures the procedures to be followed in executing transactions with LJM; in this manner, Enron can test whether it is complying with the Board's directions. (Such Approvals are to be reviewed and executed by certain members of Enron's Senior Management, including Jeff Skilling.) For example, the Checklist provides for the following determinations to be made:

- (1) In addition to LJM, identifying other sales options that were considered and rejected, including sales to Condor, JEDI II, and third parties; identifying other banks/offers that were received with respect to the transaction;
- (2) Whether the transaction with LJM will be the most beneficial alternative to Enron; identifying the related benefits – cash flow, earnings;
- (3) Determining whether the transaction involves a "Qualified Investment" so that it was required to be offered to JEDI II;
- (4) Whether the transaction was negotiated at arm's-length; did any advisors conclude that the transaction was *not* fair to Enron;
- (5) Whether the transaction had to be disclosed in the Proxy and whether it yielded any monetary benefit to an Enron employee; and
- (6) Whether LJM's participation in the transaction has been reviewed by Enron Office of the Chairman ("OTC")? Has it been reviewed and approved by Enron's Chief Accounting and Risk Officers?

And finally, the Checklist asks whether Enron's Board's Audit Committee reviewed all Enron/LJM transactions within the past 12 months.

Findings

The procedures followed by Enron in transacting with LJM, including the manner in which they have been substantiated, should be improved and can be, I believe, with minimum disruption to commercial efforts. I also believe that the adoption of certain of these recommendations will yield material benefits with respect to accounting substantiation and further documentation of the Board's carrying out of its fiduciary duties and business judgment.

The more significant areas for improvement are as follows:

- (1) Enron does not consistently seek to negotiate with third parties before it transacts with LJM. No policy exists specifically requiring evaluation and pursuit of third party alternatives before transacting with LJM. Because no existing policy requires the prior evaluation of third party alternatives and, given the fluid nature of the Company's commercial activities, too often Enron finds itself facing a time deadline that makes it difficult (*in fact* often impossible, as a practical matter) to transact with a third party, thus potentially: (a) reducing the benefits Enron realizes from the LJM transaction by eroding Enron's bargaining position; (b) clouding the objective evidence of such benefits (due to a lack of comparable alternatives) and, perhaps; (c) undermining the arm's-length nature of the transaction (due to a lack of both comparable and practical alternatives);
- (2) Enron does not always adequately substantiate in writing the procedures it follows with respect to transacting with LJM. For example, some of the questions in the Checklist do not capture the "full picture" of information that would be instructive in demonstrating compliance with Enron's Board. For example:
 - (a) The Checklist does not require an explanation as to *why* the particular transaction would be the most beneficial alternative for Enron -- only that it is. Requiring an answer to the question of *why* the transaction is beneficial would have the added advantage of requiring that the question be directly addressed by the commercial personnel charged with its execution;
 - (b) The Checklist does not provide for a detailed explanation/substantiation of sales efforts prior to transacting with LJM (thereby negating a contemporaneous record that could be useful in fashioning appropriate disclosures regarding those transactions required to be disclosed);
 - (c) The Checklist does not require an explanation as to *how* Enron determined that the transaction was conducted at arm's-length -- only if it was not (which presents the same difficulties as (b));
 - (d) The Checklist provides for pre-determined, rather than a more "realtime" OTC determination that transacting with LJM does not adversely affect Enron; and
 - (e) The Checklist does not provide any level of detail regarding the Chief Accounting and Risk's Officer's review and approval; I believe, for the Board's Audit and Finance Committee's benefit, this additional information -- when coupled with formal Board presentations -- would provide additional enhancement to the Board's decision-making as to having all relevant facts before it.
- (3) Inherent employee conflicts exist that can contribute to a perception that Enron and LJM *cannot* transact at arm's-length; and
- (4) Enron's transactions with LJM create potential conflicts with CalPERS, and perhaps other future "investment parties" with whom Enron may have a relationship.

Particular suggestions for improvements follow. These recommendations for a more "formal" approach for transacting with LJM, however, should not replace or supercede any "commonsense" alternatives that may better allow for flexibility in any commercial/financial transaction and, perhaps, a better balancing of competing interests.

Recommendations

Adoption of the suggestions that follow should enhance those procedures already in place and being followed for purposes of substantiating Enron's compliance with the Board's directives and, in particular, "completing the Company's files" with respect to responding to audit reviews and preparation of proxy and footnote disclosures. In particular:

- (1) Additional education of business units regarding the role to be played by LJM as an alternative counterparty after efforts with "traditional", third party counterparties are exhausted and the Company's expectation that such third parties will be explored before resort to LJM. Further written *substantiation* of such efforts;
- (2) Amendments to the Checklist to ensure further written substantiation of *why* this particular transaction with LJM was the *most beneficial* vis-à-vis alternatives, *how* such determination is *substantiated*, and substantiation that the transaction was conducted at arm's-length;
- (3) Better contemporaneous involvement by the OTC regarding review and approval of Enron's transacting with LJM, *i.e.* sign-off by Jeff Skilling on a more regular basis;
- (4) Mitigation of personnel conflicts by physical separation of all fulltime LJM employees from Global Finance representatives; and
- (5) Coordination of LJM Approvals, review, and substantiation documents through an internal group made up of representatives of EGF Commercial, Legal (custodian of the documents), Accounting, and Commercial Support.

Items (2) (4) and (5) above are already being addressed. We can work through the individual business unit CFOs to progress item (1) and, with your concurrence, I can discuss item (3) with Jeff.

Please let me know your thoughts about these recommendations and whether you take exception to my working towards their implementation. Of course, feel free to contact me with any questions you may have.

Thank you for your time.

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